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No. 93-823

In The

Supreme Court of the United States

October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

On Writ Of Certiorari
To The Supreme Court Of Nebraska

BRIEF OF PETITIONER

DON STENBERG
Attorney General

L. JAY BARTEL
Counsel of Record
Assistant Attorney General
2115 State Capitol
Lincoln, NE 68509-8920
Tel: (402) 471-2682

Attorneys for Petitioner

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTION PRESENTED

Whether a state tax imposed on income received by shareholders of mutual funds derived from repurchase agreements involving federal securities violates 31 U.S.C. § 3124 (1988).

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BRIEF OF PETITIONER

OPINIONS BELOW

The opinion of the Supreme Court of Nebraska (Pet. Cert. App. A-1) is reported as *Loewenstein v. State*, 244

Neb. 82, 504 N.W.2d 800 (1993). The opinion of the District Court of Lancaster County, Nebraska (Pet. Cert. App. A-20), and the Order amending the district court's opinion (Pet. Cert. App. A-27), are not reported.

JURISDICTION

The opinion and judgment of the Supreme Court of Nebraska was entered on August 27, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

31 U.S.C. § 3124 provides, in pertinent part:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax. . . .

The Supremacy Clause of the United States Constitution, Article VI, clause 2, provides, in pertinent part:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . , shall be the supreme Law of the Land. . . .

STATEMENT OF THE CASE

The controversy in this case arose as a result of the State of Nebraska's taxation of income received by Respondent John Loewenstein from investments in mutual funds. Loewenstein, a Nebraska resident, owned shares in two mutual funds, the Trust for Short-Term U.S. Government Securities and the Trust for U.S. Treasury Obligations [the "Trusts"]. The Trusts are no-load, diversified investment companies whose primary objective is to receive current income from ownership of U.S. government obligations (J.A. 61). The Trusts invest only in U.S. government obligations and distribute all of their income each year to their shareholders (J.A. 62-63).

The Trusts invest in U.S. government securities either by direct purchase of federal obligations or through "repurchase agreements", commonly called "repos" (J.A. 62). A standard repurchase agreement consists of a two-part transaction. In step one a party who holds federal obligations and who is seeking cash (the seller-borrower) sells the government obligations to a party who has available cash and who is seeking to earn interest on idle funds, the buyer-lender (in this case, the Trusts). At the time the contract is formed the buyer-lender agrees to sell back to the seller-borrower, and the seller-borrower agrees to repurchase, the obligations at a higher price than at step one. The resale price includes interest for the period of the sale. The interest paid to the buyer is less than that earned by the federal securities; the difference between the purchase price and the sale price is the seller-borrower's margin of profit (J.A. 62-63; Pet. Cert. App. A-5 to A-7). The income distributed to Loewenstein

by the Trusts flowed both from the Trusts' direct investment in federal securities and from the Trusts' participation in repurchase agreements.

Nebraska imposes a tax on an individual's "federal adjusted gross income", with certain modifications. Neb. Rev. Stat. § 77-2715(2) (1990). One such modification is an adjustment reducing income subject to taxation for "interest or dividends received by the owner of obligations of the United States . . . but exempt from state income taxes under the laws of the United States;. . . . " Neb. Rev. Stat. § 77-2716(1)(a) (Cum. Supp. 1992). In 1985, the Nebraska Department of Revenue issued a Revenue Ruling determining that income received from repurchase agreements involving federal obligations was subject to Nebraska income tax.[1] Based on the Department's Revenue Ruling,

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[1] Revenue Ruling 22-85-1 provides, in part:

> A repurchase agreement is essentially a short-term loan, bearing interest at a specified rate, whereby an owner of government or agency securities obtains funds from a customer, a financial institution, or a broker/dealer. The loan is secured by certain Treasury Bills or other obligations of the federal government owned by the borrower. The terms of the repurchase agreement generally provide for the sale of securities with a prompt repurchase by the owner. The party providing the funds does not receive the actual federal government obligations securing the investment, but does receive a collateral receipt identifying the securities pledged to or sold to the party providing the funds. The risk of ownership and title to the securities does not shift from the operator of a repurchase pool to the investor providing short-term funds. The interest earned on the United States government obligations remains the income of the owner who submitted the securities as collateral for the loan.
>
> The interest income received from repurchase agreements involving obligations of the United States government is income to the investor who provides the funds as a loan secured by government securities. This interest income which is received from repurchase agreements involving obligations of the United States government is subject to the Nebraska individual income tax. It is not to be subtracted from a taxpayer's federal taxable income on the Nebraska return.

Loewenstein was required to pay Nebraska income taxes on the interest income he received from the Trusts attributable to the Trusts' participation in repurchase agreements involving federal securities.

Loewenstein instituted a declaratory judgment action in the District Court of Lancaster County, Nebraska, asking that another Revenue Ruling relating to the taxation of income from the Trusts issued by the Department (Revenue Ruling 22-87-4) be declared invalid as contrary to 31 U.S.C. § 3124 and the Supremacy Clause of the United States Constitution (J.A. 3).[2] Subsequently, the

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[2] Loewenstein instituted the action pursuant to Neb. Rev. Stat. § 84-911(1) (1987), which provides:

> The validity of any rule or regulation may be determined upon a petition for declaratory judgment thereon addressed to the district court of Lancaster County if it appears that the rule or regulation or its threatened application interferes with or impairs or threatens to interfere or impair with the legal rights or privileges of the petitioner. The agency shall be made a party to the proceeding. The declaratory judgment shall be rendered whether or not the petitioner has first requested the agency to pass upon the validity of the rule or regulation in question.

parties jointly filed a motion to amend the pleadings to include a request for a ruling on the validity of Revenue Ruling 22-85-1. (J.A. 17). The district court found that both rulings violated § 3124 and the Supremacy Clause, and, therefore, declared them void. (Pet. Cert. App. A-20 and A-27). The State appealed the district court's decision declaring invalid Revenue Ruling 22-85-1.[3]

On appeal, a majority of the Supreme Court of Nebraska affirmed the district court's finding that Revenue Ruling 22-85-1 was invalid. The majority recognized that most courts which have considered the issue have determined that income attributable to repurchase transactions involving federal securities is not exempt from state taxation under § 3124. (Pet. Cert. App. A-11 to A-12). It declined, however, to follow this line of authority, stating "[t]he rationale applied by these courts in determining whether a mutual fund shareholder's income from a repo transaction is exempt under § 3124 is based entirely on whether that party is deemed the true, or direct, owner of the securities." (Pet. Cert. App. A-12). Stating "[w]e do not believe that direct ownership determines whether income from a repo agreement is exempt under § 3124 . . . ", the majority concluded that "the income received by the appellee in this case, at the very least, is considered indirectly in computation of the tax. In addition, the state tax clearly imposes a burden on the

[3] The State did not appeal the district court's decision finding Revenue Ruling 22-87-4 invalid. The substance of the ruling was effectively repealed by the enactment of 1991 Neb. Laws, LB 773, § 13 (*codified at* Neb. Rev. Stat. § 77-2716 (Cum. Supp. 1992)).

market for federal securities." (Pet. Cert. App. A-12 to A-13). The majority thus found "that the income received by the appellee from repo transactions executed by the trusts involving federal securities is exempt from state taxation under § 3124." (Pet. Cert. App. A-13).

In a dissenting opinion, Justice Caporale, joined by Justice Grant, expressed disagreement with the majority's opinion, stating:

> [W]hen stripped to their essence, the transactions in question are nothing more than ones in which the plaintiff-appellee, John Loewenstein, participated as a lender in loans secured by various governmental obligations. Therefore, state taxation of the income Loewenstein earned through those participations is not precluded by the Supremacy Clause of the U.S. Constitution through the provisions of 31 U.S.C. § 3124 (1988), and Nebraska Department of Revenue Ruling 22-85-1, issued by the defendant-appellant, State of Nebraska, Department of Revenue, is valid.

(Pet. Cert. App. A-14).

SUMMARY OF ARGUMENT

The Nebraska Supreme Court erroneously held that Nebraska's tax on income distributed to Respondent Loewenstein as a shareholder of mutual funds [the Trusts] derived from repurchase agreements involving federal securities was precluded by 31 U.S.C. § 3124. The computation of Nebraska's tax did not consider, directly

or indirectly, either federal obligations or the interest on such obligations within the meaning of § 3124.

The Trusts are regulated investment companies under the Internal Revenue Code Subchapter M, established under the Investment Company Act of 1940. The Trusts invest in U.S. government securities either by direct purchase of federal obligations or through "repurchase agreements", commonly referred to as "repos". The "repos" engaged in by the Trusts are agreements in which a party owning federal securities and seeking cash, the seller-borrower, "sells" the securities to the Trusts, the buyer-lender. The repo provides that the seller-borrower agrees to repurchase the securities, and the buyer-lender agrees to resell the securities, at a later date or on demand, plus an agreed upon rate of "interest" to be paid by the seller-borrower. The "interest" paid by the seller-borrower on repurchase is based on prevailing market rates paid on loans or financing transactions of similar maturity and risk; it does not bear any relationship to the interest rate or yield on the federal securities.

The economic substance of a repurchase agreement has been universally recognized as that of a secured loan in which the obligations underlying the transaction serve as collateral for what is in effect a loan of funds to the seller-borrower. Federal courts construing the exemption for interest on state and local obligations under I.R.C. § 103(a) have recognized that repurchase agreements involving municipal bonds are, in economic effect, secured loans, holding that the buyer-lender is not the true owner of the underlying securities, and, therefore, does not receive interest income exempt from federal taxation. State courts have relied on these federal court

precedents in holding that, based on the economic substance of repo transactions, income from repos involving federal obligations is not exempt from state taxation under § 3124.

While the characterization of repos may well justify different treatment in other contexts, there is no reason for the Court to depart from the well established rule that, for tax purposes, the economic substance of the transaction, rather than mere form, should govern the taxation of income derived from repurchase agreements. The provisions of the repos engaged in by the Trusts clearly establish that the agreements are, in economic substance and reality, loans by the Trusts in which federal securities serve as collateral. The "interest" received by the Trusts under their repos is merely "interest" income paid to the Trusts by private party seller-borrowers; it is not "interest" paid by the United States on the federal obligations.

Section 3124 prohibits state taxation only of obligations of the United States or the interest thereon. The Court has construed this prohibition to "'extend[ ] to **every form** of taxation that would require that either the obligations or the interest thereon, or both, **be considered, directly or indirectly, in the computation of the tax**' (emphasis supplied)." *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983). The Court's decisions confirm that the exemption extends only to forms of state taxation which "consider" obligations of the United States or the "interest" on such obligations "in computing [the] tax". Neither federal obligations, nor the interest paid by the United States on such obligations, were considered by Nebraska in computing the tax imposed on

income distributed by the Trusts to Loewenstein derived from repos. In the repurchase transactions at issue, the federal obligations were not actually owned by the Trusts, but were taken as security for what were, in economic effect, loans by the Trusts to seller-borrower/repurchasers. The obligations themselves were not "taken into account" or "included in the accounting" (*American Bank and Trust Co. v. Dallas County*, 463 U.S. at 862) in the computation of the tax, as the measure of the tax had nothing to do with the value of the federal securities. Moreover, the "interest" received by the Trusts was not the interest paid by the federal government on the obligations, but, rather, was "interest" paid by the seller-borrower/repurchasers at the rate agreed to by the parties under the repo agreements. Nebraska did not impose a tax on federal obligations or the interest thereon. The computation of Nebraska's tax on Loewenstein did not require consideration of federal obligations or the interest on such obligations. Therefore, the tax was not prohibited by § 3124.

Nor is there any support for the Nebraska Supreme Court's conclusion that the tax contravened § 3124 because it impermissibly diminished the attractiveness of federal obligations, and impaired the borrowing ability of the United States. The evidence relied upon by the court below, consisting solely of an affidavit filed in a bankruptcy case by Peter D. Sternlight, executive vice president of the Federal Reserve Bank of New York, relates only to concerns of the Federal Reserve which arose as a result of a bankruptcy court decision characterizing repos

as secured loans under the Bankruptcy Code. The treatment of repos as secured loans for bankruptcy law purposes was of importance to both the Federal Reserve and the securities industry, as, under the Code's automatic stay provisions, a secured loan characterization would have barred repo purchasers from liquidating securities in the event a seller filed for bankruptcy. Sternlight's testimony before Congress on this issue reflects the Federal Reserve was concerned with the threat to the liquidity and safety of the repo market posed by the treatment of repos under the bankruptcy laws. Congress dealt with this problem by the enactment of 11 U.S.C. § 559, which effectively neutralized these concerns by granting purchasers of securities under repos the right to liquidate the securities immediately upon a seller-repurchaser's bankruptcy. Neither Sternlight's affidavit, nor his testimony before Congress, espoused the view that state taxation of repo income posed any threat to the liquidity or safety of the repo market. Sternlight also expressed no opinion that state taxation of repo income would impair the investment attractiveness of federal securities, or that state taxation of repo income would impede the borrowing power of the United States. The record simply does not support the conclusion reached by the court below.

While the Court has recognized that the exemption mandated by § 3124 is "broad" (*Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 395 (1983)) and "sweeping" (*American Bank and Trust Co. v. Dallas County*, 463 U.S. at 862), it has also stated that the exemption "is not a tax shelter" (*First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. 583, 597 (1985)), and "should not be expanded or

modified in any degree by the judiciary." (*Smith v. Davis*, 323 U.S. 111, 119 (1944)). The Court has further counseled that it "must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly established." *Rockford Life Ins. Co. v. Dept. of Revenue*, 482 U.S. 182, 191 (1987). The extension of § 3124 by the court below to Nebraska's taxation of income distributed to Loewenstein by the Trusts resulting from repos involving federal obligations is inconsistent with the language and intent of the statute. The Nebraska Supreme Court's decision should be reversed.

ARGUMENT

NEBRASKA'S TAXATION OF INCOME RECEIVED BY SHAREHOLDERS OF MUTUAL FUNDS DERIVED FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS DOES NOT VIOLATE 31 U.S.C. § 3124.

The state court erroneously held that Nebraska's taxation of income distributed to Loewenstein as a shareholder of mutual funds derived from repurchase agreements involving federal obligations violated § 3124 because "the income received by [Loewenstein] in this case [was], at the very least, [ ] considered indirectly in the computation of the tax" (Pet. Cert. App. A-13).[4] In

[4] As noted by the amici states, several state courts have held that either § 3124 or the doctrine of intergovernmental tax immunity preclude state taxation of distributions to mutual fund shareholders based on interest received by the Trusts from direct ownership of federal obligations. Brief of Amici Curiae States of California, et al. at 4-5 n.8. Nebraska did not raise this issue in the proceedings below. Accordingly, while the Court may find that this issue is "fairly included" in the question presented within the meaning of Rule 14.1(a), Nebraska will not argue the merits of this issue.

reaching this conclusion, the state court failed to apply the proper test for determining the characterization for tax purposes of income derived from repurchase transactions, and erroneously construed and applied the scope of the exemption from taxation required by § 3124.

A. Nebraska's Tax on Income Distributed to Mutual Fund Shareholders Derived from Repurchase Agreements Does Not "Consider" U.S. Government Obligations or Interest on Such Obligations Within the Meaning of § 3124.

1. Repurchase Agreements and their Uses.

a. The Nature of Repurchase Agreements.

Repurchase agreements, or "repos", "are contracts involving the *simultaneous sale and future repurchase* of an asset, most often Treasury securities". M. Stigum, *The Money Market* 576 (3d ed. 1990) (emphasis in original). A standard repo involves a two-step transaction. In the first step, a party holding federal securities (the seller), transfers the securities to another party (the buyer), in exchange for cash. The second step consists of the contemporaneous agreement by the seller to repurchase the securities at the original sale price, plus an agreed upon amount of "interest" at a specified date (J.A. 62). The repurchase price of government securities subject to a

repo is less than the market value of the securities (J.A. 63). The repurchase price is equal to the original sale price, plus the negotiated interest. The interest paid by the seller upon repurchase is less than the interest rate accruing on the securities (J.A. 63). "The interest paid at the maturity date of the repo agreement does not bear any relationship to the interest rate or yield on the underlying security, but rather is based on the prevailing market rate paid on investments or financing transactions of similar maturity and risk." *Matter of Bevill, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557, 567 (D.N.J. 1986) ["*Bevill*"].[5]

"Despite the fact that repos and reverses take the form of sequential sales and repurchases, . . . the *economic essence* of the transaction is that it is a *collateralized loan*, not a pair of securities trades." M. Stigum, *supra*, at 577 (emphasis in original). Because, from an economic perspective, repos are recognized as collateralized loans, the "seller" is often denominated as the "borrower", and the "buyer" is referred to as the "lender". *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980).

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[5] Repurchase transactions are referred to as "repos" and "reverse repos". From the seller's perspective, the transaction is called a "repo". Viewed from the "buyer's" perspective, the transaction is called a "reverse repo". *Bevill*, 67 B.R. at 567. Technically, the repo transactions entered into by the Trusts under the General Repurchase Agreement involved "reverse repos" from the Trusts' perspective, as the Trusts were the "buyers" in these transactions (J.A. 65).

b. The Repo Market.

"Dealers first began to use the repo market to finance their positions shortly after World War II. Later, as large banks began to practice active liability management, they joined the dealers in the repo market, using it to finance not only their dealer positions, but their government portfolios. Over the years, the market, which was initially small, has grown dramatically." M. Stigum, *supra*, at 580-81. The repo market contains three types of participants: issuers, providers, and investors. Issuers include banks, savings and loans, the Federal Reserve, and private securities dealers. The primary providers of government securities include dealers underwriting new issues of government securities, the Federal Reserve, securities investors, and money market arbitrageurs. Finally, investors in the market include trust accounts, pension funds, credit unions, municipalities, money market funds, banks, savings and loans, corporations, and individuals. Comment, *The Need for a Uniform Classification of Repurchase Agreements: Reconciling Investor Protection with Economic Reality*, 36 Am. U. L. Rev. 669, 669 n.1 (1987).

Participants in the repo market use repos for a variety of reasons. The Federal Reserve, through the Federal Open Market Committee and the Open Market Desk at the Federal Reserve Bank of New York, uses repo transactions to implement monetary policy through the regulation of bank reserves. *Bankruptcy Reform: Hearing on S. 445 Before the Subcomm. on the Courts of the Senate Comm. on the Judiciary*, 98th Cong., 1st Sess. 310 (statement of Peter D. Sternlight, Executive Vice President of the Fed. Reserve

Bank of New York) [hereinafter *"Bankruptcy Reform Hearing"*]; *id.* at 339 (statement of Thomas W. Strauss, Chairman, Gov't. and Fed. Agency Sec. Div. of Public Sec. Ass'n); *SEC v. Miller,* 495 F. Supp. at 470-71); (J.A. 40). The Fed uses repos to add to bank reserves when it buys securities; conversely, when the Fed sells securities, it drains bank reserves. M. Stigum, *supra,* at 608; *Bankruptcy Reform Hearing, supra,* at 339 (statement of Thomas W. Strauss); *Bevill,* 67 B.R. at 567-68.

Repos are also utilized as a source of funding for government securities dealers. *SEC v. Miller,* 495 F. Supp. at 471; *Bankruptcy Reform Hearing, supra,* at 311 (statement of Peter D. Sternlight); *id.* at 340 (statement of Thomas W. Strauss); (J.A. 41-42). "Primary dealers" of U.S. government securities "rel[y] heavily on temporary financing through repo transactions with secondary dealers . . . and institutional customers pending resale of the issues to other investors." *Bevill,* 67 B.R. at 567; *Bankruptcy Reform Hearing, supra,* at 311 (statement of Peter D. Sternlight); (J.A. 42).

Repos also provide institutional investors with an opportunity to invest idle or surplus cash on a short-term basis. *SEC v. Miller,* 495 F. Supp. at 471; *Bankruptcy Reform Hearing, supra,* at 340 (statement of Thomas W. Strauss). "These investors include mutual funds [such as the Trusts], pension funds, state and local governments, commercial banks, thrifts, corporations, and other securities dealers. . . ." *Bankruptcy Reform Hearing, supra,* at 340 (statement of Thomas W. Strauss); *see Bevill,* 67 B.R. at 568.[6]

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[6] For additional information concerning repos and the repo market, *see generally Bevill,* 67 B.R. at 566-571; *SEC v. Miller,* 495 F. Supp. at 466-474; Note, 36 Am. U. L. Rev., *supra*; Note, *The Characterization of Repurchase Agreements in the Context of the Federal Securities Laws,* 61 St. John's L. Rev. 290 (1987); Note, *Repurchase Agreements and the Bankruptcy Code: The Need for Legislative Action,* 52 Fordham L. Rev. 828 (1984); Note, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities,* 37 Vand. L. Rev. 401 (1984).

2. In Tax Cases, the Legal Characterization of Repurchase Agreements is Determined by the Economic Substance of the Transaction.

"In cases where the legal characterization of economic facts is decisive, the principle is well established that the tax consequences should be determined by the economic substance of the transaction, not the labels put on it for property law (or tax avoidance) purposes." *Union Planters Nat'l Bank v. United States,* 426 F.2d 115, 118 (6th Cir.), *cert. denied,* 400 U.S. 827 (1970) [*"Union Planters"*] (*citing Commissioner v. P.G. Lake, Inc.,* 356 U.S. 260, 266-67 (1958)). "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering v. F. & R. Lazarus & Co.,* 308 U.S. 252, 255 (1939).

In *Union Planters,* the Sixth Circuit considered the issue of whether coupon interest collected by a bank as the owner of municipal bonds subject to repurchase agreements was exempt from federal income taxation under I.R.C. § 103(a).[7] The bank purchased municipal

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[7] I.R.C. § 103(a) provides, in part, that "[g]ross income does not include interest on – (1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;. . . ."

bonds from bond dealers, subject to agreements giving the bank the right to require the dealers to repurchase the bonds at any time at the price paid by the bank. The bank collected and retained interest on the bonds while holding the obligations, and on repurchase, the bank was credited with the pro rata interest accruing from the last coupon redemption date to the date of repurchase. 426 F.2d at 116. The bank asserted that, as it was the owner of the bonds and coupons, the interest income it received was exempt from federal income tax under § 103(a). The Government, however, contended the transactions were in reality loans secured by a pledge of the bonds. *Id.*

The Sixth Circuit rejected the lower court's finding that "'[t]he determination of this case required an inquiry into the intent of the parties.' . . . ," stating "[w]e do not agree that subjective intent is decisive here." 426 F.2d at 117. While noting that "[t]he intent of the parties may be important in determining just what their contractual relations *inter sese* were . . . ," the court stated the case "hinge[d], rather, on the legal characterization, for federal income tax purposes, of the transactions between the two parties. That characterization is not a question of fact, but rather one of law." *Id.* Following the principle that "tax consequences should be determined by the economic substance of [a] transaction", the court held "that [the] transactions, although characterized as sales-repurchases by the parties, [were to] be recognized as secured loans for federal income tax purposes, and that, accordingly, the bank, as economic lender, [could not] exclude the interest from its taxable income." *Id.* Crucial to the court's determination was the fact that the bank did not assume the risk of fluctuations in the market value of the

bonds associated with true ownership of the bonds. *Id.* at 117-18.

Consistent with the decision in *Union Planters*, other federal courts have treated repurchase agreements involving municipal bonds as secured loans, holding that the lender was not the owner of the underlying securities, and, therefore, did not receive interest income exempt from federal taxation under I.R.C. § 103(a). *First American Nat'l Bank v. United States*, 467 F.2d 1098, 1101 (6th Cir. 1972) (bank not entitled to exemption on interest earned on municipal bonds used in repos); *American Nat'l Bank v. United States*, 421 F.2d 447, 452-53 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970) (same). *But see Citizens Nat'l Bank v. United States*, 551 F.2d 832, 843 (Ct. Cl. 1977) (economic substance of transaction found to be sale-repurchase where bank not required to resell bonds, and could sell bonds to third party and retain any profit due to market value).[8] The allocation of risk of market fluctuations in the price of the obligations is a major factor considered by

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[8] Federal court decisions construing § 103 recognize that allowing the buyer-lender to claim exemption for interest income under repos involving state and local obligations would avoid the effect of I.R.C. § 265(2) (now § 265(a)(2)), which disallows deductions for interest paid on indebtedness incurred to purchase or carry tax exempt obligations. *First American Nat'l Bank v. United States*, 467 F.2d at 1101; *Union Planters Nat'l Bank v. United States*, 426 F.2d at 116. As the Sixth Circuit stated in *First American Nat'l Bank*, 467 F.2d at 1101:

> [U]nder the arrangements described herein, . . . , the bank in effect is lending money to purchase bonds and is paying no tax on the interest received. Moreover, the person who purchases the bonds from the bank in effect borrows money to buy the bonds without paying interest. This results in the double tax benefit that Congress intended to prevent by enacting I.R.C. § 265(2).

the federal courts in determining the characterization of repos for federal income tax purposes. *First American Nat'l Bank v. United States*, 467 F.2d at 1102; *Union Planters Nat'l Bank v. United States*, 426 F.2d at 118; *American Nat'l Bank v. United States*, 421 F.2d at 451-52. "Only persons having the rights and incurring the risks that ownership of municipal bonds entails may treat the interest realized by them on the municipals as tax-exempt under section 103(a)(1)." *American Nat'l Bank v. United States*, 421 F.2d at 451.[9]

Under the view adopted by the court below, a different form of "double tax benefit" occurs if income derived from repos involving federal obligations is exempted from state taxation under § 3124. The seller-borrower would receive an exemption from state taxation for interest income received on the obligations. In addition, the Trusts, as the buyer-lender, would also receive an exemption from state taxation for income paid by the seller-borrower to the Trusts under the repo and passed on to the Trusts' shareholders. Section 3124 should not be construed to require an exemption for both the party who owns federal obligations and receives the interest income paid on such obligations, and to also require exemption from state taxation of income paid by the seller-borrower to the Trusts derived from their loans secured by federal obligations.

[9] The Internal Revenue Service has identified several factors indicating that a repurchase transaction constitutes a secured loan, and not a sale of securities. I.R.S. Rev. Rul. 74-27, 1974-1 C.B. 24. Among the factors indicative of a loan are: (1) whether the seller can require the purchaser to resell the securities, and whether the identical securities are bought and sold; (2) whether the purchaser can require the seller to repurchase the securities; (3) whether the agreement provides for a specific remedy in the event of default by either party; (4) whether the seller agrees to pay interest at a stipulated rate between sale and resale; and (5) whether the amount advanced does not necessarily equal the value of the securities sold. *Id. See also* I.R.S. Rev. Rul. 82-144, 1982-2 C.B. 34 (purchaser of municipal obligations

State courts have relied on these federal court precedents construing the exemption under I.R.C. § 103(a) in holding that, based on the economic substance of the transaction, income derived from repos involving federal obligations is not exempt from state taxation. *See, e.g., Comptroller v. First United Bank*, 320 Md. 352, 373-75, 578 A.2d 192, 202-203 (1990); *Department of Revenue v. Page*, 541 So. 2d 1270, 1273-75 (Fla. Dist. Ct. App. 1989); *Andras v. Dept. of Revenue*, 154 Ill. App. 3d 37, 42-45, 106 Ill. Dec. 732, ___, 506 N.W.2d 439, 443-44 (1987), *cert. denied*, 485 U.S. 960 (1988). *See also Everett v. Dept. of Revenue*, 470 N.W.2d 13, 15 (Iowa 1991) (*citing Andras v. Dept. of Revenue* and *Department of Revenue v. Page*); *Massman Const. Co. v. Director of Revenue*, 765 S.W.2d 592, 595 (Mo. 1989) (stating court "reserve[d] the right to characterize the substance of transactions without regard to their form, when precise distinctions are legally significant."); *In re Thomas Sawyer Estate*, 149 Vt. 541, 545, 546 A.2d 784, 786 (1987) (*citing American Nat'l Bank v. United States*); *Capital Preservation Fund, Inc. v. Dept. of Revenue*, 145 Wis. 2d 841, 847-48, 429 N.W.2d 551, 554-55 (Wis. Ct. App. 1988) (*citing Andras v. Dept. of Revenue*). While the question presented concerns a state's taxation of income derived from repurchase agreements involving federal obligations, no principled reason exists to ignore the Court's long-standing view that tax consequences should be based on "substance and realities",

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deemed owner entitled to exempt interest income notwithstanding purchase of "put" agreements providing taxpayer option or right to require seller to repurchase obligations).

Helvering v. F. & R. Lazarus & Co., 308 U.S. at 210, and not mere form.[10]

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[10] Petitioner acknowledges that the characterization of repos may differ based on the context in which such transactions are analyzed. Whether a repo is deemed a secured loan or a purchase and sale depends on the context in which the characterization is made. Note, 61 St. John's L. Rev., *supra*, at 309 n.98.

In the context of the bankruptcy laws, courts generally characterized repos as purchase and sale securities transactions rather than as secured loans. *Bevill*, 67 B.R. at 598 (repo agreements "contracts for the sale of securities and their resale back to the original seller at a future date"); *Financial Corp. v. Occidental Petroleum Corp.*, 634 F.2d 404, 404-05 (8th Cir. 1980) (one week repurchase transaction held a sale and agreement to repurchase); *Gilmore v. State Bd. of Admin.*, 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980) (repos treated as purchase and sale in bond transaction). *In re Lombard-Wall, Inc.*, No. 82 B 1156 (Bank. S.D.N.Y. Sept. 16, 1982), however, held that a repo constituted a secured loan and the securities merely collateral. Under this ruling, the automatic stay provisions of the Bankruptcy Code barred repo purchasers from liquidating securities in the event a seller filed for bankruptcy prior to the repurchase date. The decision in *Lombard-Wall* caused considerable concern in the securities industry and on the part of the Federal Reserve over the continued liquidity and safety of the repurchase market. *See generally Bankruptcy Reform Hearing, supra*. Congress responded to *Lombard-Wall* by enacting § 559 of the Bankruptcy Code (11 U.S.C. § 559). Section 559 effectively neutralized the adverse consequences raised by the *Lombard-Wall* decision by granting purchasers of securities under repos the right to liquidate the securities immediately upon a seller's bankruptcy. Any proceeds from the sale of securities in excess of the agreed repurchase price, however, are deemed property of the estate.

In the context of the securities laws, the trend in cases brought under the anti-fraud provisions of Section 10(b) of the Securities and Exchange Act of 1934 has been to treat repos as

3. The Economic Substance of a Repurchase Transaction is that of a Collateralized Loan, and Not a Purchase and Sale of the Underlying Federal Obligations.

It is generally recognized that the economic substance of a repurchase agreement supports a secured loan characterization. *SEC v. Miller*, 495 F. Supp. at 467; M. Stigum, *supra*, at 577 ("*economic essence* of the transaction is that it is a *collateralized loan*"); *see First American Nat'l Bank v. United States*, 467 F.2d at 1101; *Union Planters Nat'l Bank v. United States*, 426 F.2d at 118; *United States v. Erickson*, 601 F.2d 296, 300 n.4 (7th Cir.), *cert. denied*, 444 U.S. 979 (1979). "The seller retains many attributes of

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"purchases and sales" of securities. *SEC v. Drysdale Securities Corp.*, 785 F.2d 39, 42-43 (2d Cir.), *cert. denied*, 476 U.S. 1171 (1986) (alleged misrepresentations made with respect to financial condition of company involved in repo market in federal government obligations made in connection with purchase or sale of securities for purposes of Act's prohibition against fraudulent conduct in connection with purchase and sale of securities). Certain policy factors underlying the Securities and Exchange Act, including broadly construing the terms "purchase" and "sale" to effectuate the Act's remedial purpose and considering whether a sale characterization will advance the purposes of the Act, are considered in determining the characterization of repos in the securities law context. *First Nat'l Bank of Las Vegas v. Estate of Russell*, 657 F.2d 668, 676 (5th Cir. 1981). Indeed, the Court has held that a "pledge" of securities transferring a security interest may constitute a "purchase or sale" of securities for purposes of the federal securities laws. *Rubin v. United States*, 449 U.S. 434, 428-30 (1981).

The fact that repos may be categorized differently for purposes other than taxation in the bankruptcy and securities law (or other) contexts should not alter the test to be employed in determining the legal characterization of repos for tax purposes.

ownership and most terms of the agreement are more typical of a secured loan than a sale." Note, 52 Fordham L. Rev., *supra*, at 837.

First, the absence of exposure to risk of price fluctuations in the market value of the obligations strongly indicates that ownership remains with the seller-borrower. The seller-borrower's "obligation to repurchase the securities at a specified price insulates the buyer from any risk of market fluctuations." Note, 52 Fordham L. Rev., *supra*, at 837-38; *see American Nat'l Bank v. United States*, 467 F.2d at 1101; *Union Planters Nat'l Bank v. United States*, 426 F.2d at 118.

The price structure of the transaction is also indicative of a secured loan. While, in a sale of securities, the price is generally the fair market value, the market value of securities subject to a repo generally exceeds the purchase price. *SEC v. Miller*, 495 F. Supp. at 469-70; M. Stigum, *supra*, at 580. The difference between the market price of the securities and the amount of money transferred serves as a "margin" to insulate the buyer-lender against adverse market shifts should the buyer-lender be forced to liquidate the security in the event of default. *SEC v. Miller*, 495 F. Supp. at 469; M. Stigum, *supra*, at 580.[11] The establishment of the repurchase price also supports a secured loan characterization. While, in a sale transaction, the price would be based on expectations as to future market price, in a repo, the repurchase price is

[11] The differential between the market value of the securities and the sale price is referred to in the trade as the "haircut". *Bevill*, 67 B.R. at 567, M. Stigum, *supra*, at 580.

the initial sale price. M. Stigum, *supra*, at 576 ("seller buys back the asset at the same price at which he sold it", plus "interest"). Thus, the pricing structure of a repo is indicative of a loan and not a sale.

Repos also usually contain a "mark-to-market" provision giving the buyer-lender the right to require the seller-borrower to transfer additional securities if the market value of the original securities declines below a certain level. *SEC v. Miller*, 495 F. Supp. at 470; Note, 52 Fordham L. Rev. at 839. This provision, intended to further insulate the buyer-lender from risk of loss upon default, "is characteristic of a secured loan, but inconsistent with a sale." Note, 52 Fordham L. Rev., *supra*, at 839.

The retention by the seller-borrower of the right to retain interest earned on the underlying obligations during the period of the repo also indicates that a repo is properly categorized as a loan and not a sale. *SEC v. Miller*, 495 F. Supp. at 467 (parties to repo "customarily provide that any interest accruing on the securities between the dates of the initial purchase and subsequent 'repurchase' remains the borrower's property"). Moreover, while the buyer-lender, in the event of default by the seller-borrower, has the right to sell the securities, repos customarily provide that any excess of the liquidation price above the repurchase price must be paid to the seller-borrower by the buyer-lender. Note, 52 Fordham L. Rev., *supra*, at 840. "Such a transfer of sale proceeds is hardly consistent with the characterization of the buyer-lender as owner of the securities. Rather, this disposition of sale proceeds is typical of a secured transaction with the holder of collateral seeking to satisfy a secured claim." *Id.*

Several state courts have upheld the taxation of income realized by business trusts resulting from

repurchase agreements involving federal obligations, recognizing that, despite the parties' characterization of the transactions as constituting a sale and repurchase, the transactions are, in substance, secured loans in which the obligations serve as collateral. *Everett v. Dept. of Revenue*, 470 N.W.2d at 14-15 ("repurchase agreements, despite their name, are actually secured loans"); *Comptroller v. First United Bank*, 320 Md. at 367-75, 578 A.2d at 200-203 ("the substance of the transaction for tax purposes is a loan by the trust to the seller-borrower, secured by the pledge of government obligations"); *Department of Revenue v. Page*, 541 So. 2d at 1275 ("Trust does not have the risks or rights associated with ownership", and thus is "not the true owner of the federal obligations under the repurchase agreements"); *In re Thomas Sawyer Estate*, 149 Vt. at 545, 546 A.2d at 786 ("[w]hen holding federal obligations as part of a repurchase agreement, the Trust holds them, in essence, as security for a loan to the original purchase of the federal obligations"); *Capital Preservation Fund, Inc. v. Dept. of Revenue*, 145 Wis. 2d at 847, 429 N.W.2d at 554 (interest paid to Trust "not interest on the transferred and retransferred government securities, but rather is the equivalent of interest on the Trust's 'loan' to the bank"); *Andras v. Dept. of Revenue*, 154 Ill. App. 3d at 44, 106 Ill. Dec. at ___, 506 N.E.2d at 444 ("the Trusts accepted none of the risks of ownership, and we therefore conclude that the transactions were secured loans rather than sales").[12]

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[12] The "Trust" involved in each of these cases was the Trust for Short-Term U.S. Government Securities. *Everett v. Dept. of Revenue*, 470 N.W.2d at 13; *Comptroller v. First United Bank*, 320 Md. at 354, 578 A.2d at 193; *Department of Revenue v. Page*, 541 So. 2d at 1270; *In re Thomas Sawyer Estate*, 149 Vt. at 542, 546 A.2d at 784; *Capital Preservation Fund, Inc. v. Dept. of Revenue*, 145 Wis. 2d at 842, 429 N.W.2d at 552; *Andras v. Dept. of Revenue*, 154 Ill. App. 3d at 38, 106 Ill. Dec. at ___, 506 N.E.2d at 440. This is one of the two Trusts invested in by Loewenstein. (J.A. 3-4; 61).

An examination of the "General Repurchase Agreement" typically used by the Trusts when engaging in repos illustrates that, in economic substance, the transactions were loans by the Trusts to the seller-borrowers in which the federal obligations functioned as collateral (J.A. 65-71). The Agreement is a master contract providing terms under which the Trusts, registered investment companies (referred to as the "Fund") engaged in repos with seller-borrowers, referred to as the "Seller". The subject matter of the repos is "obligations issued or guaranteed by the United States Government or agencies thereof, ('Eligible Securities')." (J.A. 65). The "Sale Price" is the initial sale price as agreed to by the parties. The repurchase price, to be paid by the seller-borrower on a specified date or on demand by either party, is the "Sale Price" "plus interest at the agreed upon interest rate ('Interest Rate')." (J.A. 65-66).

The initial step in a repo transaction consists of the Seller transferring the "Eligible Securities" to the Fund's "Custodian", and the Trust causing the "Sale Price" to be credited to the account of the Seller in immediately available funds. (J.A. 66). During the repo period, the seller-borrower must maintain on a daily basis a margin of at least 102 percent of the sale price in "Eligible Securities" with the "Custodian". (J.A. 66, 69-70). The market value of the securities is determined by the bid quotations on

the immediately preceding business day, plus accrued interest on the obligations. (J.A. 66).

The seller-borrower has the right under the Agreement to withdraw securities transferred to the Custodian and to substitute other "Eligible Securities" of a value sufficient to maintain the required margin. (J.A. 68).[13] If the seller-borrower satisfies the margin requirements, the Trusts also agree "to pay over to Seller as soon as received all principal, interest and other sums paid by or on behalf of the issuer in respect to the Securities and collected by the [Trusts]. . . . " (J.A. 69). If the seller-borrower fails to maintain margin, the Trusts "may retain any such sums as Cash Collateral. . . . " (J.A. 69). If the market value of the Eligible Securities, plus any Cash Collateral, exceeds the margin percentage, the seller-borrower may require the Trusts to pay the excess to the seller-borrower. (J.A. 70).

Failure of the seller to repurchase on time constitutes an event of default, as are the seller's misrepresentation of its financial condition or the seller's filing for relief under the bankruptcy laws. (J.A. 71-72). Upon payment by the seller of the Sale Price plus Interest, "the [Trusts] agree[ ] to resell such securities and pay over all principal, interest and other sums paid by or on behalf of the

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[13] In contrast, the Agreement contains no provision allowing the Trusts to obtain the Eligible Securities from the Custodian, or permitting the Trusts to transfer or sell such securities for their own accounts, absent a default by the seller-borrower. (J.A. 73). Indeed, the Trusts "agree[ ] that [they] will not resell or register the Securities unless an event described in paragraph 13 [Seller Events of Default] shall have occurred." (J.A. 69).

issuer in respect thereof collected by the [Trusts]" not previously paid over to the seller-borrower. (J.A. 66).

The Agreement also provides that "in the event that a repurchase transaction hereunder is deemed not to be a sale" the "Seller shall be deemed to have hereby granted to the [Trusts] a first security interest in and lien upon, and to have pledged the Cash Collateral and Securities." The Agreement also provides that "[n]otwithstanding the foregoing sentence, it is the intention of the Seller and the [Trusts] that each such transaction shall be a 'sale' within the meaning of the New York Uniform Commercial Code." (J.A. 78).

In *Comptroller v. First United Bank*, 320 Md. 352, 578 A.2d 192, the Court of Appeals of Maryland reviewed the provisions of a "master repurchase agreement" virtually identical to that utilized by the Trusts.[14] Finding that, "[a]lthough the transaction [was] in form a sale and repurchase, and despite the intention of the parties to effect a sale", the court found "the substance of the transaction for tax purposes is a loan by the Trust to the seller-borrower, secured by the pledge of government obligations." *Id.* at 371, 578 A.2d at 201. The court noted the following characteristics of the transaction leading to the conclusion that the repurchase transactions constituted secured loans:

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[14] The identity of the two agreements is evident upon comparison of the Maryland court's discussion of the "master repurchase agreement" (320 Md. at 368-70, 578 A.2d at 200) and the "General Repurchase Agreement" attached to the Second Stipulation of Facts in this case (J.A. 65-81).

As step one 'purchaser', the Trust does not bear the risk of fluctuations in the market value of the United States obligations as would an owner of the securities. The repurchase price is fixed at the first step and remains uninfluenced by subsequent market events. Nor is the price paid for the securities at step one intended to be market value, as might be expected in a purchase of securities. Under the margin requirements, market value must be at least 102% of the sale price.

The seller-borrower is also required to post additional securities if the minimum margin requirements are not maintained. This strongly indicates that the transfer of government obligations to the Custodian is to secure the seller-borrower's promise to repurchase, *i.e.*, to repay the funds used by the seller-borrower plus interest at the agreed rate. That indication is reinforced by the default provisions. Upon the seller-borrower's failure to repurchase when promised, the Trust may sell the obligations, and any excess sales proceeds over the amount of the seller-borrower's obligations are paid to the seller-borrower. Were the Trust the owner of the securities, the proceeds of a sale would be the Trust's.

Furthermore, during the term of the repo, income produced by the government obligations is applied to the benefit of the seller-borrower, either as cash collateral, if required, and if not, then payable to the seller-borrower from time to time or at termination. An owner by purchase of the securities would be entitled to the income.

Id. at 371-72, 578 A.2d at 201.

In addition to the decision of the Maryland Court of Appeals in *Comptroller v. First United Bank*, virtually every other state court addressing the issue has concluded that income from repos involving federal securities distributed to mutual fund shareholders is not exempt under § 3124, as the economic reality of the transaction is that the securities merely serve as collateral for what is in economic effect a loan by the Trusts to the seller-borrower, and the Trusts do not receive interest income from the securities, but, rather, are paid "interest" on the loan by the seller-borrower at the rate agreed to by the parties.[15] "[T]he decisions of the state courts, particularly if

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[15] *Everett v. Dept. of Revenue*, 470 N.W.2d at 14-15; *Department of Revenue v. Page*, 541 So. 2d at 1275; *In re Thomas Sawyer Estate*, 149 Vt. at 545, 546 A.2d at 786; *Capital Preservation Fund, Inc. v. Department of Revenue*, 145 Wis. 2d at 849, 429 N.W.2d at 554; *Andras v. Dept. of Revenue*, 154 Ill. App. 3d at 45, 106 Ill. Dec. at ___, 506 N.E.2d at 444. In addition, state courts applying similar reasoning have upheld state taxation of income derived from repos received by taxpayers engaging directly in repo transactions, as opposed to income received by shareholders of mutual funds. *Hammond Lead Products, Inc. v. Tax Com'rs*, 575 N.E.2d 998 (Ind. 1991) (taxpayer "did not own the securities" and, therefore, not entitled to exemption) (*distinguished Department of Revenue v. Hardware Wholesalers, Inc.*, 622 N.E. 2d 930, 934 (Ind. 1993) (fund transactions between taxpayer and bank under repurchase agreements not "deposits" exempt from intangibles tax); *Massman Const. Co. v. Director of Revenue*, 765 S.W.2d at 594-95. *See also Borg v. Dept. of Revenue*, 308 Or. 34, 39, 774 P.2d 1099, 1102 (1989) (income from Trust's dealings in repurchase agreements not exempt, as income paid by seller and not "interest" paid by United States on obligations). A Michigan appellate court concluded that shares in a mutual fund which invested in federal obligations were exempt from an intangibles tax, without discussing the repo issue. *Matz v. Dept. of Treasury*, 155 Mich. App. 778, 401 N.W.2d 62 (1986). While *Matz* is not persuasive

they are uniform and concur in their reasoning, are worthy of respectful consideration, even if the question be, at last, a Federal one." *Plummer v. Coler*, 178 U.S. 115, 120 (1900). The reasoning employed by these courts is compelling, and should be adopted by this Court. The Trusts, for tax purposes, do not own the federal securities which, in economic substance, serve as collateral for loans by the Trusts to the seller-borrowers. The interest earned by the Trusts is not interest paid by the federal government on the obligations; rather, the income earned by the Trusts is the "interest" paid by the seller-borrowers on repurchase.

4. Nebraska Does Not "Consider" U.S. Government Obligations or Interest on Such Obligations in Computing its Tax on Income Distributed to Mutual Fund Shareholders Derived from Repurchase Agreements.

The court below, while not finding that the Trusts directly owned federal obligations under their repurchase agreements, nevertheless held the state's tax on income from repos received by the Trusts and distributed to Loewenstein

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authority simply because of its absence of any analysis of the issue, it has also been distinguished in a later Michigan case, *H.J. Heinz Co., Inc. v. Dept. of Treasury*, 197 Mich. App. 210, 215, 494 N.W.2d 850, 853 (1992), where the court stated that it "agree[d] with those courts which classify repo transactions as collateralized loans rather than as purchases and sales." The state court majority opinion did not directly address the issue, stating "[w]e do not believe that direct ownership determines whether income from a repo agreement is exempt under § 3124." (Pet. Cert. App. A-12).

violated § 3124 because "the income received by" Loewenstein was, "at the very least, considered indirectly in the computation of the tax." (Pet. Cert. App. A-13).[16] This conclusion simply cannot be squared with the language of § 3124, or this Court's decisions construing the scope of the exemption required by the statute.

31 U.S.C. § 3124 provides, in pertinent part:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both to be considered in computing a tax. . . .

Section 3124 is a revision and recodification of Rev. Stat. § 3701, as amended, 31 U.S.C. § 742 (1976). Section 3701, as amended, provided, in part:

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[16] The manner in which the state court phrased its finding is admittedly confusing. Obviously, the "income" received by Loewenstein was "considered . . . in the computation of the tax", as the tax at issue is Nebraska's individual income tax. Undoubtedly, what the court below meant was that, in the majority's view, Nebraska's taxation of the income distributed to Loewenstein violated § 3124 because the income he received was based on consideration of federal obligations or interest on such obligations. This is the view urged by Respondent. (Brief in Opp. to Petition at 11-12) ("The economic reality is that whatever income the Trusts derive from these transactions arises in consideration of the federal obligations that are subject to the transaction."). As will be discussed at pages 34-40, *infra*, this interpretation is at odds with the scope of the exemption under § 3124.

> [A]ll stocks, bonds, Treasury notes and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax,. . . .

Title 31 of the United States Code was not enacted into positive law until 1982, when it was reformulated "without substantive change." *See* Act of Sept. 13, 1982, Pub. L. No. 97-258, § 4(a), 96 Stat. 877, 1067. Since the recodification did not substantively change the statute, decisions construing § 742 are binding authority in the construction of § 3124.

The Court has "treated [§ 3124] as principally a restatement of the constitutional rule [that federal government property is immune from state taxation.]" *Memphis Bank & Trust Co. v. Garner,* 459 U.S. 392, 397 (1983). "The 1959 addition to § 3701 did not broaden the scope of the exemption required by § 3701 beyond that mandated by the Constitution. . . . " *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. 583, 593 (1985). The exemption for federal obligations provided by § 3701, as amended, has been recognized as "sweeping: with specific exceptions, it 'extends to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation* of the tax' (emphasis supplied)." *American Bank and Trust Co. v. Dallas County,* 463 U.S. 855, 862 (1983) (*citing Memphis Bank & Trust Co. v. Garner,* 459 U.S. at 395-96). "Under the plain language of the 1959 amendment . . . the tax is barred regardless of its *form* if federal

obligations must be considered, either directly or indirectly, in *computing* the tax." *American Bank and Trust Co. v. Dallas County,* 463 U.S. at 862 (emphasis in original). "The tax exemption required by the Constitution and § 3701 is not a tax shelter." *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. at 597.

American Bank and Trust Co. v. Dallas County involved a Texas property tax on bank shares. The tax "was computed by use of an 'equity capital formula' which involved determining the amount of the bank's capital assets, subtracting from that figure the bank's liabilities and the assessed value of the bank's real estate, and then dividing the result by the number of shares." 463 U.S. at 862-63. The Court determined the tax took "into account, at least indirectly, the federal obligations that constitute[d] a part of the bank's assets." *Id.* at 863. The Court further stated that, "[g]iving the words of amended § 3701 their ordinary meaning, there can be no question that federal obligations were considered in computing the bank shares tax at issue here. In context, the word 'considered' means taking into account, or included in the accounting." *Id.* at 862 (footnote omitted). Finding that § 3701 "prohibit[ed] any form of tax that would require consideration of federal obligations in computing the tax", *id.* at 865, the Court held the bank shares tax "violated the plain language of § 3701." *Id.*

American Bank and Trust Co. v. Dallas County confirms that § 3124 extends only to forms of state taxation which "consider" U.S. obligations or the "interest" on such obligations "in computing [the] tax." Neither federal securities, nor the interest on federal securities, were considered in the computation of Nebraska's tax on

income distributed from the Trusts to Loewenstein derived from repurchase agreements. In a repurchase transaction, the federal obligations are not actually owned by the Trusts, but are taken as security for what is, in economic effect, a loan by the Trusts to the seller-borrower/repurchasers. The obligations themselves are not "taken into account" or "included in the accounting" (*American Bank and Trust Co.*, 463 U.S. at 862) in the computation of the tax, as the measure of the tax has nothing to do with the value of the federal obligations. Moreover, the "interest" received by the Trusts is not the interest paid by the federal government on the obligations, but, rather, is interest paid by the seller-borrower/repurchasers at the rate agreed to by the parties as part of the repo agreement. The "interest" income received by the Trusts was paid by the seller-borrower/repurchasers, not the federal government.

Addressing the same issue presented in this case, the Supreme Court of Iowa stated:

> The United States Constitution Article VI clause 2 and 31 U.S.C. § 3124(a) prohibit any form of state taxation which requires an obligation of the United States Government or the interest thereon to be considered in computing a tax. Here the interest was not on the federal obligations but on the repo agreements; it was paid not by the federal government, but by the seller-repurchasers. Moreover, it was those seller-repurchasers, not the federal government, that set the interest rate to be paid under the repurchase agreements, and indeed the interest rates paid pursuant to the repo's were different from those paid on the federal obligations.

> The State's tax did not consider, either directly or indirectly, the federal obligations or the interest paid on them in calculating the Everetts' tax. Instead, the tax was based on the interest paid by private seller-repurchasers pursuant to a private sector loan agreement in which federal obligations served as collateral. In such a situation, neither the federal obligations nor the interest thereon is considered in calculating the state income tax. . . . [N]either the supremacy clause nor 31 U.S.C. section 3124(a) prevents the State from taxing the income derived from the repurchase agreements.

Everett v. Dept. of Revenue, 470 N.W.2d at 15. *Accord In re Thomas Sawyer Estate*, 149 Vt. at 545, 546 A.2d at 786 ("[w]hile the repurchasing agreements nominally involve federal obligations, the profits derived therefrom are not interest income attributable to the federal obligations"; "[t]he income gained by the Trust from these arrangements is therefore interest income on the loan the Trust provides the seller, rather than interest income derived from the federal obligation, and is not exempt from state taxation under § 3124(a)."); *Borg v. Dept. of Revenue*, 308 Or. at 39, 774 P.2d at 1102 (repo "income is not paid by the United States or other issuer but by the seller at the time of repurchase. It is not 'interest' paid by the United States, which in fact may pay no interest to anyone during the period between sale and purchase"); *Hammond Lead Products, Inc. v. Tax Com'rs*, 575 N.E.2d at 1001 ("the interest on the U.S. obligations, paid by the U.S. government to the Bank, was not taxed by the State. Hammond Lead received interest income pursuant to its agreement with the Bank and was properly taxed").

In *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, the Court held that § 742 did not require a state to allow a bank to deduct the full value of its federal securities from its gross assets in computing a bank shares tax. The Court recognized that, because the bank may have incurred liabilities, the interest on which was also deductible, to acquire the securities, the statute was satisfied by the state's allowing only a pro-rata deduction from the bank's net worth for the securities. The Court concluded that the bank should not be permitted to use the federal obligations to "shelter taxable income." 470 U.S. at 595. Similarly, in this case, Loewenstein should not be allowed to "shelter" taxable income distributed by the Trusts, which income results not from the Trusts ownership of federal securities, but, rather, from the Trusts loan of funds to seller-borrowers which is repaid with interest. Section 3124 does not require that either the Trusts or Loewenstein be permitted to shelter from Nebraska's tax income in the form of interest paid to the Trusts by seller-borrowers under repurchase agreements secured by federal securities.

Neither the plain language of § 3124 nor the history of the 1959 amendment indicates that Congress intended to accomplish anything other than to abandon formalistic distinctions between acceptable and unacceptable forms of state taxation of federal obligations and interest paid on such obligations. As the Court stated in *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, Congress, by enacting the 1959 amendment, "intended to abolish the formalistic distinction between taxes **on** income and taxes **measured by** income . . . [N]othing in the legislative history indicate[s] that Congress understood the addition

to broaden the scope of the exemption, as well as to clarify the form of taxes to which the exemption applied." 470 U.S. at 594 (emphasis in original).[17] The exemption asserted by Loewenstein is far removed from the concerns articulated by Congress in adopting the 1959 amendment. The income subject to Nebraska tax in this case is, in substance, interest paid by private party seller-borrower/repurchasers on loans which used federal obligations as collateral. Simply put, the tax imposed did not "consider" U.S. obligations in its computation, nor did it "consider" interest paid on such obligations. Consequently, Nebraska's tax does not violate § 3124.

Section 3124, by its terms, is directed only at forms of state taxation which "consider" U.S. government obligations or the interest on such obligations "in computing [the] tax". Both the court below and Loewenstein misconstrue the plain language and intent of the statute to mandate exemption of "income" derived from transactions "in consideration of federal obligations." Brief in Opp. to Petition at 11-12. The statute, however, speaks only in terms of prohibiting taxes which, in their computation, consider the obligations or the interest paid by the federal government on the obligations; it says nothing about state taxation of income resulting from commercial

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[17] The Court noted that the "catalyst" for the 1959 amendment was an Idaho statute imposing a tax on individuals "according to and measured by [their] income." Idaho had taken the position that, while states could not tax income received on federal obligations, it was not required to exempt income received on federal obligations from "gross income" from which taxable net income was derived. *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. at 594.

transactions which, at most, only peripherally involve such obligations or interest. Indeed, Loewenstein's argument, taken to its logical conclusion, would require states to exempt from taxable income interest earned on direct loans between private parties secured by federal securities. Such a construction of § 3124 is plainly untenable.[18]

B. Nebraska's Taxation of Income of Shareholders of Mutual Funds Derived from Repurchase Agreements Does Not Diminish the Marketability of Federal Securities and Does Not Impair the Borrowing Ability of the United States.

In finding that Nebraska's taxation of repo income distributed by the Trusts to Loewenstein violated § 3124, the court below found that the state's tax "clearly impose[d] a burden on the market for federal securities." (Pet. Cert. App. A-13). Relying on the deposition testimony of Peter D. Sternlight, executive vice president of the Federal Reserve Bank of New York, the majority

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[18] Indeed, even if Loewenstein is correct in his claim that the repos engaged in by the Trusts should be recognized as actual sales and repurchases of federal obligations, under which the Trusts actually owned the securities, Nebraska's tax would only constitute a tax on income derived from the gain on sale of the federal obligations. Interest paid by the United States on federal obligations is the only form of income exempt from state taxation under § 3124. There is no requirement that a state exempt income received based on gain realized from the sale of federal obligations. *See Willcuts v. Bunn*, 282 U.S. 216, 227-30 (1931) (upholding federal taxation of gain on sale of state obligations); Brief of Amici Curiae States of California, et al. at 13-17.

concluded "that a state tax on such income would diminish the market value and the investment attractiveness of federal securities, that the tax would impose a burden on the federal government's regulation of the nation's money supply, and that such tax would increase the costs to the federal government in financing the national debt." *Id.* The record simply does not support this conclusion.

Section 3124 is "principally a restatement of the constitutional rule [that federal government property is immune from state taxation.]" *Memphis Bank & Trust Co. v. Garner*, 459 U.S. at 397. "The 1959 addition to § 3701 did not broaden the scope of the exemption required by § 3701 beyond that mandated by the Constitution. . . . " *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. at 593. One of the principal purposes of the intergovernmental tax immunity doctrine is to prevent "States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability." *Rockford Life Ins. Co. v. Dept. of Revenue*, 482 U.S. 182, 190 (1987). "[T]he long established congressional intent [of § 3124 is] to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure the necessary credit." *Smith v. Davis*, 323 U.S. 111, 117 (1944). The intent of the statute, however, is "to immunize from state taxation only the interest-bearing obligations of the United States needed to secure credit to carry on the necessary functions of government. That intent . . . should not be expanded or modified in any degree by the judiciary." *Id.* at 119. *See also Rockford Life Ins. Co. v. Dept. of Revenue*, 482 U.S. at 191-92 (noting Court's observation in *Smith v. Davis* as to scope of the statutory immunity for federal obligations is "relevant to

our role in applying the constitutional doctrine as well. . . . ").[19]

A review of the Sternlight deposition reveals that Mr. Sternlight expressed no opinion as to the effect of state taxation of income from repos involving federal obligations.[20] The substance of his testimony is contained in his

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[19] The court below referred to the language in *Smith v. Davis* regarding congressional intent "to prevent state taxes which diminish in the **slightest degree** the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit. (Pet. Cert. App. A-12) (emphasis in original). It is important to note, however, the context in which the Court expressed this view in *Smith v. Davis*. At issue in *Smith v. Davis* was whether § 3701, the predecessor to § 3124, precluded a state property tax assessed on the value of an open account claim against the United States. The Court concluded that § 3701 did not prohibit the tax because the open account claim was not within the class of "other obligations" exempted under § 3701. 323 U.S. at 116-119. Thus, the language in *Smith v. Davis* referred to by the court below related to the Court's definition of the scope of the term "other obligations" under the immunity statute. This passage does not, as suggested by the court below, indicate that the Court has established a broad construction of § 3124 which bars any state tax which has any effect, however remote, which could diminish the value or investment attractiveness of federal obligations. The Court in *Smith v. Davis* simply defined the nature of the obligations exempted by the statute. Indeed, the Court's decision supports a reading of § 3124 which does not unduly expand the exemption required by the statute to matters beyond those encompassed by its terms. *Id.* at 117 ("[t]ax exemptions being the exception rather than the rule, much clearer language evidencing an intent to immunize open account claims under Section 3701 is necessary. . . . ").

[20] Mr. Sternlight's deposition was part of the evidence before the Florida court in *Department of Revenue v. Page*, 541 So. 2d 1270. (J.A. 22).

affidavit, attached to the deposition (J.A. 39-44). This affidavit was submitted by Mr. Sternlight in the bankruptcy proceedings involving Bevill, Bresler & Schulman Asset Management Corporation (J.A. 39); *Bevill*, 67 B.R. at 565 (referring to Sternlight affidavit).

The adverse consequences to the repo market which could result from failure to recognize repos as constituting true sales and repurchases of the underlying obligations, articulated in Mr. Sternlight's affidavit, were expressed in the context of the Federal Reserve's concern as to the characterization of repos for bankruptcy law purposes. *In re Lombard Wall* held that repos constituted secured loans and the securities were merely collateral. Thus, under the automatic stay provisions of the Bankruptcy Code, repo purchasers were barred from liquidating securities in the event a seller filed for bankruptcy prior to the repurchase date. *Lombard Wall* caused considerable concern in the securities industry and on the part of the Federal Reserve over the continued liquidity and safety of the repurchase market. *See generally Bankruptcy Reform Hearing, supra*. Mr. Sternlight testified before the Senate Subcommittee on the Courts of the Senate Committee on the Judiciary during the Bankruptcy Reform Hearing. Noting the various purposes for which repos were used by the Federal Reserve, government securities dealers, and investors, he testified as to the concerns of the Federal Reserve should repos be treated as secured loans rather than sales for bankruptcy purposes:

> The common element in all these extensive uses of repo agreements is liquidity. Without that characteristic, the repurchase agreement would not serve the function that it now does. As you

know, recent developments have threatened the liquidity of the market – namely, by raising the possibility that the automatic stay provisions of the Bankruptcy Code may be applied to an investor's holdings of securities under a repo. A holder who would not be able to meet his contract at maturity would clearly have his liquidity impaired. This possibility has raised uncertainties among repo market participants, and has caused some to curtail their operations or even withdraw entirely from the market. The total effect is not yet severe for the overall market, but has the potential for becoming so.

Bankruptcy Reform Hearing, supra, at 306.

Mr. Sternlight also submitted a prepared statement to the Subcommittee. *Id.* at 310-315. A comparison of this statement and the contents of the affidavit in evidence in this case reveals that many of the statements contained therein are similar or virtually identical. Both Mr. Sternlight's statement to the Subcommittee and his affidavit in the *Bevill* case are directed toward the Federal Reserve's concerns over the treatment of repos for bankruptcy law purposes; they make no mention of any concern due to state taxation of repo income. Indeed, Mr. Sternlight, in a written response to the inquiry of the Chairman of the Committee on the Judiciary of the U.S. House of Representatives as to whether the proposed bankruptcy amendment regarding repos would "have any effect on the characterization of repos under the tax laws", stated that enactment of the amendment "should not affect the characterization of repos under the tax laws because these bills do not characterize, for either tax or bankruptcy purposes, repurchase agreements as either secured

loans or as purchases and sales." *Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary,* 98th Cong., 2d Sess. 106. Expanding on the Federal Reserve's position, Mr. Sternlight further stated that, "while the Federal Reserve has gone on record as favoring purchase-and-sale characterization of repurchase agreements, **that statement is limited to a bankruptcy context and should not be taken as an endorsement of purchase-and-sale characterization for tax, accounting, or other purposes.** *Id.* at 106-107. (emphasis added).[21]

The record plainly does not support the Nebraska Supreme Court's conclusion that Nebraska's tax on income distributed to Loewenstein by the Trusts resulting from repos involving federal obligations impermissibly burdens federal obligations or interferes with the borrowing ability of the United States. The affidavit of Peter Sternlight, relied upon by the majority below, contains

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[21] The concerns expressed to Congress by the securities industry were also limited to the context of the treatment of repos under bankruptcy law. Thomas W. Strauss, Chairman of the Public Securities Association, "a national trade association representing 300 banks, brokers, and dealers who underwrite and sell U.S. Government and Federal agency securities," referred to Mr. Sternlight's testimony "describ[ing] the problem in the repo market brought about by the Lombard-Wall bankruptcy proceeding and related events." *Bankruptcy Reform Hearing, supra,* at 307. His testimony reflects that the industry's concern related to the treatment of repos in bankruptcy proceedings, and he acknowledged that "repos may be characterized as one of several types of transactions, for tax law, securities law, and many other purposes." *Id.* at 308.

nothing to support such a conclusion. The majority simply took his statements and used them wholly out of context. Mr. Sternlight expressed no view whatsoever as to the effect of state taxation of repo income. "[W]hen the effort is made . . . to establish the unconstitutional character of a particular tax by claiming that its remote effect will be to impair the borrowing power of the government, courts in overturning statutes, long established and within the ordinary sphere of state legislation, ought to have something more substantial to act upon than mere conjecture. The injury ought to be obvious and appreciable." *Plummer v. Coler,* 178 U.S. 115, 137-38 (1900). The decision of the court below violates this principle. It is based on nothing more than pure speculation and conjecture as to the alleged "impact" of state taxation of repo income on the federal government.

The Nebraska Supreme Court also failed to give proper consideration to the Court's decision in *Rockford Life Ins. Co. v. Dept. of Revenue,* 482 U.S. 182 (1987). In *Rockford Life,* the Court addressed whether "Ginnie Maes" were exempt from state taxation under the federal government's constitutional immunity from taxation or under the immunity statute. The Court held that "Ginnie Maes" were not entitled to exemption on either ground, finding that these instruments did not constitute obligations of the United States, and, therefore, were not immune from state taxation. In holding the instruments did not constitute obligations of the United States under the immunity statute, the Court noted that, while the instruments contained a pledge of the "full faith and credit of the United States", they were "neither direct nor certain obligations of the United States . . . ," as the issuer

bore "the primary obligation to make timely payments – the United States' obligation [was] secondary and contingent." *Id.* at 188.

As to the claim of constitutional immunity, the Court noted the instruments contained no "binding promise by the United States to pay specified sums at specified dates." *Id.* at 189-90 (*quoting Smith v. Davis,* 323 U.S. at 115)). As one of the principal purposes of the intergovernmental tax immunity doctrine is to prevent "States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability . . . ", the Court concluded that "[t]he lack of a fixed and certain obligation by the United States in the Ginnie Mae context ma[de] this concern far too attenuated to support constitutional immunity." *Id.* at 190 (citations and footnote omitted). Moreover, "none of the proceeds of the issuance and sale of the [Ginnie Mae] certificates [were] received by the Federal Government or used to finance any governmental function." *Id.* at 191.

The reasoning in *Rockford Life* applies in this case. There is no direct and certain obligation of the United States government to the Trusts under the repurchase agreements. The agreements, by their terms, specify that the Trusts will not receive the monies promised by the federal government in the securities which are the subject of the repurchase transaction (J.A. 69). In the event of default by the seller-borrower, the Trusts may sell the obligations at their then-current market value to yet another party and obtain cash from that party (J.A. 73). Thus, the federal government does not even stand as a guarantor in relation to the Trusts.

Moreover, as in *Rockford Life*, the federal government never receives the proceeds of the repurchase transactions. The proceeds flow between private parties, the underlying federal obligations already having been issued at the time the repurchase transaction takes place. This further undermines the majority's finding that exemption was required because "the state tax impose[d] a burden on the market for federal securities." (Pet. Cert. App. A-13). Given the nature of repurchase transactions, it is difficult to conceive how taxation of income derived from repos and distributed to shareholders of the Trusts imposes an impermissible burden on the borrowing power of the federal government. Absent "a significant effect on the marketability or interest costs of federal securities," . . . , attempts to "find grounds for derivative tax immunity in every speculative marginal advantage for those who deal with the government and therefore to the government pushes the search for an economic incidence (as distinct from the legal incidence) of a tax too far." *Borg v. Dept. of Revenue*, 308 Or. at 40, 774 P.2d at 1102 (*citing* Tribe, American Constitutional Law 514-18 (2d ed. 1988)).

CONCLUSION

Section 3124 does not require that Nebraska exclude from taxable income distributions from the Trusts received by Loewenstein resulting from repurchase agreements involving federal obligations. The income derived from these transactions and distributed by the Trusts to shareholders such as Loewenstein is simply interest paid to the Trusts as a result of private sector loan

agreements in which federal obligations served as collateral. Moreover, there is nothing in the record to support the state court's conclusion that Nebraska's taxation of this income would impermissibly burden federal securities, or impair the borrowing ability of the United States. The decision of the Supreme Court of Nebraska should be reversed.

Respecfully submitted,

DON STENBERG
Attorney General
Petitioner

BY DON STENBERG
Attorney General

L. JAY BARTEL
Assistant Attorney General
Counsel of Record
2115 State Capitol
Lincoln, NE 68509-8920
Tel: (402) 471-2682

Attorneys for Petitioner.